Tortoise QuickTake
Credit Podcast

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Welcome to the Tortoise QuickTake podcast. Thank you for joining us. Today, Tortoise provides a timely update on trending topics in the market.

Welcome to this week's Tortoise credit podcast. I'm John Heitkemper, portfolio manager for high yield bonds and leveraged loans at Tortoise.

In a humbling indication of my age, I couldn't muster the nerve to follow my daughters onto a roller coaster a few weeks ago. It wasn't even a particularly daunting ride, but I still feared losing my over-priced, theme park lunch all over my fellow vacationers. Recent action in U.S. financial markets offered nearly the same gyrations, minus the cotton candy and corn dogs.

At the beginning of last week, the market's consensus view called for the Federal Reserve to cut its benchmark Fed Funds target by 25 basis points, the first cut in over a decade, in an effort to head off potential risks of trade tension and foreign economic weakness. Despite unemployment hovering near 50-year lows, there were a few outlying forecasters calling for a more aggressive 50 basis point cut, but regardless of timing, Fed Fund futures indicated that the market had priced in 50-75 basis points of easing in 2019. When a 25 basis point cut – and a relatively benign policy statement – hit the wire on Wednesday, market reaction was understandably muted. The calm didn't last long, though, as the tone of Fed Chair Powell's press conference proved decidedly more hawkish than financial markets were expecting. In particular, Powell's characterization of the cut as just a "mid-cycle adjustment" – rather than the first step in a multi-cut effort to extend the economic cycle – rattled markets, sending stocks down, short-end Treasury yields higher and credit spreads modestly wider. Powell did try to walk back his hawkish tilt later in the Q&A, but by that time, it was clear that the market wanted more accommodation than the Fed believed necessary.

This is not the first time that Powell's message caused market indigestion. In this case, it's not clear whether Powell's remarks reflect an underlying disagreement on the board – two voters dissented, after all – or the challenges of Fed communication in the Trump era. With the President putting continuous pressure on the Fed to cut aggressively, is Powell reticent to acknowledge that more cuts are likely coming?

In all likelihood, the question is probably moot, as investors had less than 24 hours to digest Powell's words before President Trump stunned markets with the announcement that the U.S. would soon impose a 10% duty on the remaining $300 billion of Chinese imports that are not already subject to tariffs. While economists estimate that the direct hit to the economy is probably only a tenth or two of GDP growth, this escalation clearly raises the downside risks and probably forces the FOMC to cut again in September, a move that was uncertain right after Powell's testimony.

Any lingering doubt was quickly erased as the U.S. walked in on Monday to find that China had responded to Trump by cancelling purchases of U.S. agricultural goods and letting its currency devalue vs. the dollar. The yuan plunged to its lowest levels in a decade, which should soften the tariff hike by making Chinese goods cheaper, but maybe more importantly, it strikes a nerve with the U.S. President, who will no doubt consider ways to devalue the dollar in response. Let the currency wars begin!

With the Powell trade two-punch combo, the U.S markets are clearly on their heels. As we write this, the S&P 500 is down over 5% from its pre-FOMC high and 10-year Treasuries are down to 1.75%, the lowest level since the President was elected. With global economic growth at risk of further slowing, investors have hammered commodities as well, with oil losing 8% on Thursday alone.

As if all of those thunderstorms aren't enough to ruin a summer vacation, a risk that might be overlooked right now is the deceleration of U.S. corporate earnings growth, a trend that we've been watching closely on the credit side at Tortoise. With about 80% of the market value of the S&P having reported 2nd quarter results, it looks like year-over-year earnings growth will come in barely positive at +0.6%, according to Credit Suisse. One notable figure is that of the companies that have provided 3rd quarter guidance, more than half were below street estimates, the worst tally since the 2015 commodity sector crash. This is likely to place additional pressure on second half earnings estimates, which are probably overly optimistic as the trade landscape deteriorates further.

The three major themes this past week – a seemingly reluctant Fed, heightened trade risks, and an uninspiring earnings picture – support our relatively cautious stance on credit. Yes, valuations are off the recent tights, but we still don't believe that investors are fully compensated for shaky fundamentals. In the high yield universe, default rates remain low, but credit metrics deteriorated in the 1st quarter for the first time in three years and will likely weaken further under the current earnings trajectory. Investment grade credit metrics are arguably in worse shape, relatively speaking, and many of those companies are likely to continue favoring shareholders as equity valuations slide and financing rates decline. The one bright spot we see is on the technical side, where global demand for U.S. bonds – including U.S. credit – should remain healthy against a backdrop of roughly $14 trillion of negative yielding securities that exist in most of the other major developed markets. That being said, technicals can change quickly, and in the current environment, the roller coaster seems like too much to stomach.

Thanks for listening, and please tune in for future Tortoise credit podcasts.

Thank you for joining us. And stay tuned for our next cast. Have topics you want covered or other feedback to share? Write us at info@tortoiseadvisors.com.